BUSINESS NZ

PLANNING FORECAST

MARCH 2021

BusinessNZ

NZ Economy: Managing Risks

Executive Summary

Many economic indicators point to the NZ economy being in a holding pattern, the consequence of Covid-19 which sprang unexpectedly onto the international and domestic scene over a year ago. The advent of Covid-19 has heightened the need for effective risk management strategies to deal with significant events that occur from time to time, whether they be natural disasters, such as earthquakes and floods, or a pandemic such as Covid-19 that has gained such a foothold in the international economy.

It is important to understand that the management of risk involves trade-offs and that the idea we can have our cake and eat it too doesn't work in reality. Economists often talk about there being an optimal amount of risk mitigation since, generally, past a certain point, the cost of reducing risk becomes progressively greater for incremental risk reductions.

The Treasury is currently consulting on the long-term fiscal challenges NZ could face over the next 40 years and this will hopefully provide insights into how these can be met and what options and trade-offs will need to be considered.

With respect to climate change, there are difficult decisions to be made regarding how hard and how fast NZ can (or should) go in reducing gross carbon emissions to reach a net zero emissions target by 2050 and what part carbon sinks (such as forestry) or longer term, international trade, should play in gaining (or selling) carbon credits.

In the health sector, the recent announcement of a PHARMAC review may or may not look at the speed with which new drugs are rolled out to treat certain conditions.

In relation to transport, decisions are needed as to how best to reduce the risk of premature death or severe injury, for example, whether by straightening roads or by requiring vehicles travelling on roads to have greater safety features.

The current Government also faces some hard and politically difficult decisions over managing the health effects of Covid-19 while minimising its adverse impact on the economy and people's overall economic and social well-being. Difficult, controversial, but important issues must be resolved - those relating to the overall cost per life saved through various government support programmes and regulatory interventions, for example.

With the above mind, it is important to have a consistent framework enabling the Government and the broader public to understand the nature of current risks and to make decisions appropriate to the degree of risk involved. Currently, many New Zealanders, and particularly the business community, feel there is no clear pathway forward for dealing with Covid-19 – given it is likely to be with us for some time yet. But ad hoc decisions will have a chilling effect on investment.

Some recent BusinessNZ Network briefings have consistently shown many firms are close to the edge in terms of ongoing financial viability and need clear guidance as to what exactly is the Government's plan for the future. The CEO of the Employers and Manufacturers Association (Northern) Brett O'Riley recently said *"…..firms need more certainty around future planning for border restrictions, alert level management, vaccines, testing and tracing. A plan for the future is critical to the survival of many of these businesses."*

HIGHLIGHTS

The BusinessNZ Economic Conditions Index, a measure of NZ's major economic indicators, sits at 11 for the March 2021 quarter, down 2 on the previous quarter and up 17 on a year ago. It was inevitable there would be a significant improvement over the second half of the year and into 2021 as businesses and households emerged from various stages of lock-down.

NZ's economic growth rate is forecast to be modest until the border is properly reopened. Until then, NZ will face the continued prospect of a two-speed economy with some sectors and regions growing while others struggling or going backwards. Yo-yoing in and out of various alert levels (lockdowns) is also unhelpful in this respect.

This two-speed economy is reflected in forward looking indicators over a range of sectors. In the positive camp, the BNZ-BusinessNZ Performance of Manufacturing Index (PMI) has shown a solid recovery from the historic lows experienced in mid-2020.

The building and construction sector is generally improving with record consenting for residential housing, but supply chain constraints continue to impact on the supply of materials, causing delays and forcing up prices.

Agricultural sentiment has increased on the back of firming commodity prices, reflected in Fonterra's recent forecast increase for the current year.

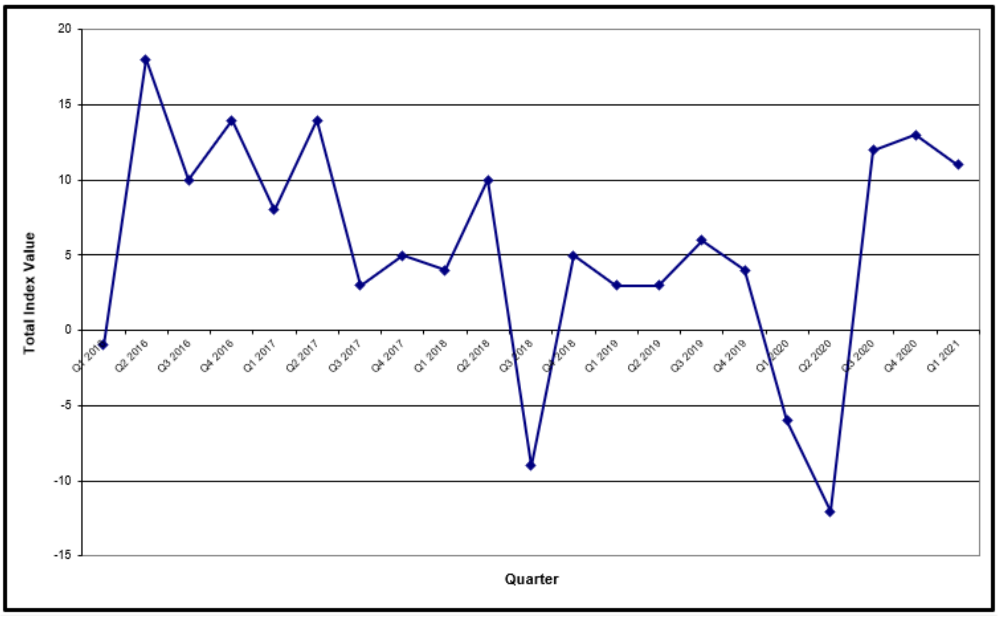
The BNZ-Business NZ Performance of Services Index (PSI) is still below par, given COVID-19's impacts , particularly on tourism and hospitality, and the likelihood the border will be closed for some time, despite the likelihood of opening of a trans-Tasman bubble soon.

PART 1: THE NZ ECONOMY – WHERE ARE WE NOW?

BusinessNZ Economic Conditions Index (ECI)

The overall BusinessNZ Economic Conditions Index (a measure of NZ's major economic indicators) sits at 11 for the March 2021 quarter, down 2 on the previous quarter and up 17 on a year ago. This significant improvement since mid-2020 needs to be read in the context of a massive drop in economic growth over the June 2020 quarter as a direct result of the strict lockdown imposed in late March 2020. Since then, the economy has bounced back somewhat despite Auckland in particular re-entering varying phases of lock-down over the intervening period.[1]

Overall Economic Conditions Index (ECI)



Source: BusinessNZ

Data in the ECI is broken into four key sub-groups:

- Economic growth/performance indicators
- Monetary policy/pricing indicators
- Business/consumer confidence indicators
- Labour market indicators

Economic growth/performance indicators sit at 5 for the March 2021 quarter, the same as the previous quarter and up 5 on a year ago. Trade flows and prices took a hit over the second half of 2020 but are recovering. Shipping capacity is still stretched, leading to delays and potential cost increases for some sectors.

Monetary policy/pricing indicators sit at -1 for the March 2021 quarter, down 3 on the previous quarter and down 5 on a year ago. Interest rates are now at historic lows although longer term rates are starting to increase on the back of increased pricing intentions and strong asset price growth in particular sectors, including housing.

Business/consumer confidence indicators sit at 5 for the March 2021 quarter, up 2 on the previous quarter and up 12 on a year ago. Business and consumer confidence indicators have shown significant improvement of late, although they have come off an historical low base last year on the back of Covid-19. Uncertainty is still playing on the minds of many businesses with the on-again off-again changes in alert levels.

Labour market indicators sit at 2 for the March 2021 quarter, down 1 on the previous quarter and up 5 on a year ago. Unemployment rates did not reach previously anticipated levels as significant government initiatives, such as wage subsidies and assistance packages, helped to ensure individuals remained attached to the labour market to the degree possible. Notwithstanding, businesses are having extreme difficulty in securing skilled migrant labour with an essentially closed border impacting on a range of sectors across the broader economy, from horticulture to high-end infrastructure projects.

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[1] The ECI tracks over 30 indicators on a quarterly basis. The overall index value for any one quarter represents the net balance of the indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. Note: The results for the March quarter 2021 are estimates based on available information to date.

<u>Note</u>: Given a very fluid international and to some extent domestic situation at present, the forecasts below, including with respect to economic growth, interest rates, exchange rates, inflation, and unemployment, should be seen for what they are – the best available information to date. Some banks are currently updating their forecasts while other forecasts will likely be subject to significant change as both the global and the domestic scenes continue to evolve over coming months.

<u>PART 2: THE NZ ECONOMY – WHERE ARE WE HEADING?</u>

1.1 Economic growth (GDP) – Risks remain

Forecasts out to March 2023 show economic growth improving but risks remain, both domestically and internationally. In the near term, several factors are likely to constrain growth with little expected this calendar year.

Continued closed borders, as expected, are having significant effects.

- A lack of foreign tourists particularly impacting on certain regions with many businesses hanging on by a thread.
- The inability to source foreign expertise and skilled and unskilled migrant labour adversely affecting returns, infrastructure projects and the ability of the agricultural and horticultural sectors to undertake important seasonal work.
- A lack of foreign students impacting on revenue in the higher (tertiary) education sector.
- The troubling lack of a comprehensive plan for opening up the border - and under what circumstances - creating great uncertainty for the business community and the communities it supports. As mentioned earlier, these risks must be managed appropriately with a clear understanding of the trade-offs involved.

The International Monetary Fund (IMF) in its Concluding Statement (which describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission') to member countries (March 11, 2021)), has generally heaped praise on NZ's management of the Covid-19 crisis, particularly in terms of suppressing infection and enabling faster-than-expected economic recovery.

Notwithstanding, the IMF also pointed out that the recovery has been uneven, with some sectors and employees suffering greater adverse effects.

And the IMF notes the problem of a rapid rise in asset prices, including housing, and associated affordability and financial vulnerabilities, and considers a comprehensive policy response is required, including measures to unlock supply, dampen speculative demand, and buttress financial stability.

Beyond the pandemic, the IMF is of the view the Government should continue to strengthen structural reforms to promote the economy's productive capacity. For example, the current review of the Overseas Investment Act (OIA) is an opportunity to streamline the foreign investment approval process and deepen connectivity with global markets. In this respect the IMF welcomes the Government's intention to use the new national interest test sparingly.

But by far the biggest news on the international and domestic fronts is the successful development and roll-out of vaccines, with some countries, including Israel, having already vaccinated close to half of their population. Several other countries are not far behind with many international health experts very satisfied with the early impact of the vaccines.

The issue of vaccine rollouts is interesting, with each country generally adopting its own rules and processes. Some are taking a more conservative approach to potential rollouts and others, like NZ, are more towards the back of the pack. While the Government has announced the timeframe for a progressive roll-out of the Pfizer vaccine (of which the Government has now secured an extra 8.5 billion doses, enough for every New Zealander, plus booster shot), it is unlikely to achieve the 90 percent vaccination by the end of the year which the Director-General for Health is targeting.

Many in the business community, indeed the wider community, are getting Covid-fatigue, comparable to the situation which occurred some time after the Christchurch earthquakes a decade ago. Going into and out of different alert levels is taking its toll, and without any evidence of a plan, is causing ongoing nervousness in the business community.

While businesses accept there are risks, they want to know more clearly what the plan is for opening the border, under what circumstances etc. enabling them also to plan. This is especially true for those sectors which are subject to the vagaries of border closures, such as tourism and hospitality. Ad hoc decision-making is not helpful and will have a chilling effort on investment which will ultimately flow through reduced output and employment.

The yo-yoing into and out of various lockdown alert levels is also taking its toll, particularly given that Auckland has faced several snap lockdowns. The Auckland region is responsible for close to 40 percent of NZ's Gross Domestic Product (GDP) so these lockdowns have a severe impact, particularly when they persist for any length of time.

Supply chain issues are still a significant problem adding to cost pressures and delays in getting the materials that are essential if businesses are to progress at pace. Combined with very strict controls on the ability to source foreign expertise for key projects, supply chain issues have delayed some projects while others have simply been put on hold or canned completely.

A dramatic reduction in commercial air passenger travel has increased the cost of air freight and forced more exports on to ships, ultimately affecting supply chains globally. According to research conducted among more than 270 New Zealand exporters, top barriers to doing business have changed substantially from previous years, with the cost of logistics and transport shooting into the top spot, followed closely by COVID-19-related costs and the costs of doing business generally.

The impact of Covid-19 is also having an effect beyond the business sector with some households reporting a degree of mental trauma significantly affecting the age of those requiring counselling and treatment – some as young as 10 or 11 have needed assistance.

On the other hand, certain factors allow for a more positive outlook:

- The world economic outlook has improved over recent weeks, no doubt underpinned by the progressive roll-out of vaccines, while NZ's largest trading partner, China, continues to go from strength to strength.

The Organisation for Economic Cooperation and Development (OCED) in its latest OECD Economic Outlook Report (March 2021) has stated that global economic prospects have improved markedly in recent months, helped by the gradual deployment of effective vaccines, announcements of additional fiscal support measures in some countries, and signs that economies are using better measures to suppress the virus.

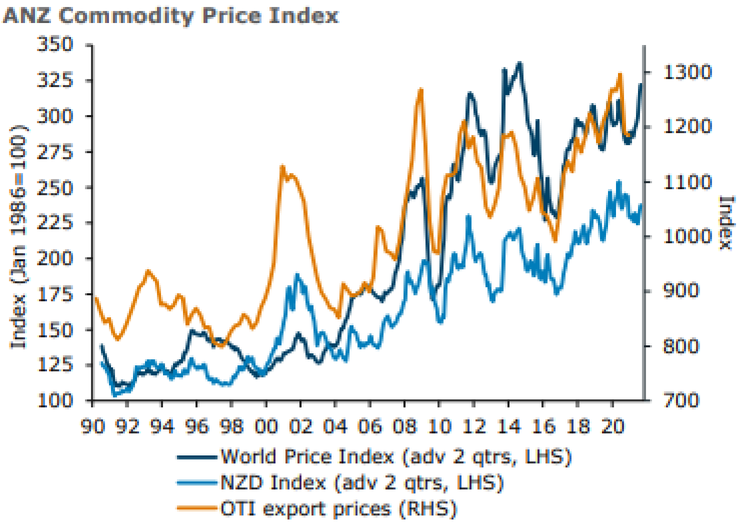
Global GDP growth is projected to be 5.5 percent in 2021 and 4 percent in 2022, with global output rising above the pre-pandemic level by mid-2021.

Significant stimulus packages, particularly in the United States, are expected to have a considerable impact on US GDP growth this year, with welcome demand spillovers for other trading partners. While longer-term interest rates are starting to increase, the increase is off a low base though still adding fuel to the equities fire with the Dow Jones Index going from strength to strength as new highs are reached almost daily.

Again, as with NZ, the OECD has expressed concern about the cost pressures beginning to emerge due to a resurgence in global demand and temporary supply disruptions.

- World commodity prices remain at healthy levels, with protein (including dairy) prices holding up well. This was reinforced recently by Fonterra announcing an upward firming in the expected milk payout for the current 2020/21 season.

The latest ANZ Commodity Price Index graph for February 2020 shows world commodity prices lifting 3.3 percent, to reach their highest level since April 2014. Dairy is to the fore, supported by strong prices for meat, forestry, and aluminum.



Source: ANZ, Stats NZ

When converted into local prices, the index gained 2.7 percent, as the Trade Weighted Index (RWI) gained a further 0.6 percent.

- The Government's books, as outlined in the Half Year Economic and Fiscal Update (December 2020), while taking a hammering, are not as bad as predicted in the pre-Election Economic and Fiscal Update. Notwithstanding, the massive increase in both government (taxpayer) and rising household debt will need to be paid off at some stage by current and future generations of NZers. There is no free lunch here, making NZ vulnerable to further shocks.

The continued monetary stimulus package (around $100 billion of quantitative easing, the slashing of the OCR and the introduction of the Reserve Bank's Funding for Lending Programme (FLP), which will provide up to $28 billion of cheap funding for the major banks) should ensure both businesses and households can continue to borrow to support growth.

Unfortunately, loose monetary policy does not come without cost. NZ household debt now sits at an historic high with much of it tied into the housing market. Ironically, at the same time, debt servicing costs are at their lowest level for well over two decades. The Reserve Bank's very loose monetary policy stance (the "no-regrets policy") is having a significant impact on asset prices (particularly housing) that will extend the gap between the haves and have nots.

Forecasts: Real GDP percent Growth

	Years Ending		
	Mar 21	Mar 22	Mar 23
Highest	-2.2	5.1	4.2
Average	-2.5	4.7	3.4
Lowest	-2.9	4.1	2.3

Source: ASB, BNZ, Kiwibank and Westpac

1.2 Monetary Policy – all things to all people?

The Reserve Bank's mandate has increased radically since the days when it was simply required to target inflation.

There have been significant changes to how the Reserve Bank operates and its mandate has expanded to ensure NZ's financial system remains in a solid position to weather both the significant economic impact of COVID-19 and to support NZ's recovery, but these moves, requiring the Bank to be all things to all people, are likely to prove problematic.

Targeting inflation (and even perhaps sustainable full employment) is one thing, adding requirements on climate change and housing are probably steps too far. There are things the Reserve Bank can do well (particularly targeting inflation through interest rates) but matters such as rising asset prices in respect to housing are well outside the Bank's ability to control. They are fundamentally a consequence of central and local government regulatory policies relating to land availability and housing development. Putting the onus on the Reserve Bank to consider matters of this kind when setting monetary policy (beyond the extent to which the Reserve Bank already considers them in the context of financial stability) is, in fact, buck passing.

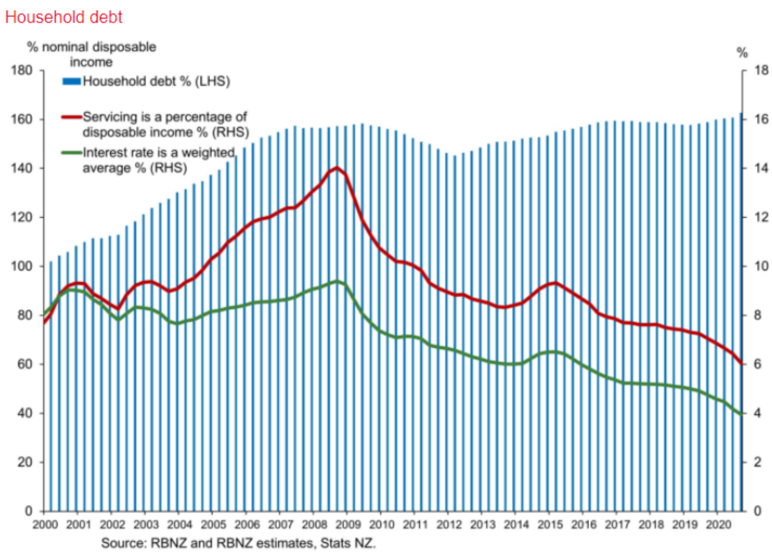
Having multiple, and potentially conflicting objectives will provide little certainty to businesses. It raises the issue of why the Reserve Bank Act was introduced in the first place - notably, to provide for independence from the Muldoon government's early 1980s approach which directed the Bank to pursue policies which best met the political objectives of the day. While we are a long way from going back to that situation, to be effective, the policy prescription must fit the problem identified rather than ad hoc policies implemented to try and curb demand.

While the Government has recently announced a housing package, it is principally around measures that will try and blunt demand rather than seriously dealing with supply-side issues. While some proposals are likely to be helpful such as proposals for greater investment, there will be business concerns surrounding the lack of clarity with interest deductibility. Deductibility of interest payments for business expenditure is a long-held principal of the NZ tax system. Any changes should be approached with a considerable degree of caution given the potential to increase the complexity of the tax system.

Interest Rates – low for longer?

As expected, the raft of instruments rolled out by the Reserve Bank over the last year has seen interest rates plummet to their lowest levels in over 50 years with 90-day bank bills expected to remain low out to March 2023. While last year and early this year there was talk of potentially negative interest rates, it would be fair to say that the Reserve Bank's appetite for such policies may have waned somewhat given the NZ economy has proved more resilient to the effects of COVID-19 than perhaps most forecasters earlier contemplated. Nevertheless, negative interest rates cannot be ruled out, despite their potential for unintended consequences, their effect on households' savings and expenditure decisions (saving more or delaying expenditure assuming prices will drop even further) and the likelihood of further fuelling asset price rises (particularly with respect to housing).

It is important to realise that most businesses and households welcome lower mortgage interest rates as these have resulted in debt servicing costs being their lowest for a very long time (despite household debt levels being the highest they have ever been). But low interest rates will not necessarily encourage businesses and households to start investing; low interest rates have their own risks.



The impact of very low interest rates and normal supply and demand factors on housing is now well recognised with reputable data providing eye watering statistics on their impact on house prices.

The Real Estate institute of NZ has recently released statistics showing the impact of rising houses prices, not only in the main metropolitan centres but increasingly in provincial regions as well.

The core danger is that if (or when) mortgage interest rates rise, the potential impact on some borrowers could be horrific. Research by the ANZ Bank suggests that that an increase in interest rates from say 3 to 4 percent could impact on household net incomes in Auckland by around 5 percent and around 3 percent in the wider NZ community.

The Fear of Missing Out (FOMO) is driving house prices further with the many in society assuming house prices and/or equities won't fall as neither the Reserve Bank nor the Government, will let this happen. Unfortunately, this is naïve thinking. Unsustainable debt levels will come home to roost at some stage – particularly as interest rates rise over time, which they will do.

While many are placing faith in the Government's potential reform of the Resource Management Act (RMA) to speed up house builds, two things need to be considered. First, reforms will take some time to be implemented given the sheer scale of the Act while there are dangers in proceeding at pace without adequately recognising potential unintended consequences.

Second, one of the key issues will be ensuring individuals and businesses can build at scale without undue constraints imposed by others, particularly vested interests, opposed to development of any kind. This will not be easy.

On the other hand, possibly many people assume that given house prices have continued to rise with an effectively closed border, they will go on rising as the border is progressively reopened. Perhaps this is based on a further (naïve) assumption that Government policy making will allow relatively unfettered access for migrants wanting to come to NZ to live and/or work. This is unlikely to be the reality.

The other factor likely to weigh on future interest rate levels is the direction of the NZ dollar over the next year (see below). Any further increase in the NZ NZ dollar should act to keep a lid on significant interest rate rises.

Forecasts: Interest Rates (90-day bills)

	Years ending		
	Mar 21	Mar 22	Mar 23
Highest	0.4	0.4	1.4
Average	0.3	0.4	0.8
Lowest	0.3	0.3	0.3

Source: ASB, BNZ, Kiwibank and Westpac

The NZ dollar – steady does it?

While the NZ dollar has tended to remain in a relatively tight zone in relation to the Australian dollar, the same cannot be said for the NZ dollar against the US greenback.

The relative strength of the NZ dollar of late is perhaps not surprising given that improvements in "riskier currencies" tend to go hand in hand with an improved international outlook associated with improving commodity prices.

Historically, compared with the US dollar, the NZ dollar is relatively closely tracked to the fortunes of international commodity prices, particularly dairy prices.

So-called safe currencies such as the US dollar and the Swiss franc tend to do better when there is significant global uncertainty but tend to fall out of favour as confidence improves.

With the roll-out of vaccines well underway and the gradual re-opening of the global economy, investors are likely to take on more risk. And with global commodity prices increasing significantly on the back of renewed demand, it is likely the NZ dollar will show further gains over the coming year, particularly against the US dollar, as can be seen from the forecast below. Against the Australian dollar, the rate of forecast change is more nuanced.

While exchange rates have not necessarily been front of mind for most exporters recently, any exchange rate increase will put downward pressure on prices to NZ producers, including agricultural producers, when converted back into NZ dollars. This may make it easier for the Reserve Bank to keep inflation within the broader target band of 1-3 percent per annum but will lower the returns to producers.

It will also potentially impact on returns for many investors in listed exporters such as Fisher and Paykel Healthcare, and Mainfreight, although some of these companies have, ironically, benefitted as a direct result of the pandemic in that there has been greater global demand for many healthcare-related devices, and logistics, particularly those of direct relevance to Covid-19 mitigation.

Forecasts: Exchange Rates

AUD (cents)			
	Mar 21	Mar 22	Mar 23
Highest	0.94	0.93	0.93
Average	0.93	0.92	0.92
Lowest	0.92	0.91	0.92

USD (cents)			
	Mar 21	Mar 22	Mar 23
Highest	0.73	0.78	0.79
Average	0.72	0.75	0.74
Lowest	0.70	0.71	0.71

TWI			
	Mar 21	Mar 22	Mar 23
Highest	76.3	78.2	75.7
Average	74.9	75.4	74.2
Lowest	73.4	73.0	72.9

Source: ASB, BNZ, Kiwibank and Westpac

Inflation – upward pressure?

Inflation as measured by the Consumers' Price Index is likely to remain within the Reserve Bank's target band of 1-3 percent out to March 2023 although forecasts expect some further increases over the next couple of years.

While most commentators have focused on the potential downside risk of inflation tracking below the 1-3 percent target, there is also the possibility of an inflation increase arising from an increase in new housing-related costs (land and second-hand houses are not included the CPI) and the potential for significant increases in insurance premiums as a result of numerous factors such as earthquake and climate change risks and a broader move towards more risk-based pricing for those properties seen as vulnerable. Some risks too will likely be felt in other insurance areas, spilling over into health-related insurance policies and life cover.

There are also questions over supply chain cost increases which will ultimately feed through into consumer costs with the New Zealand Institute of Economic Research's (NZIER) latest Consensus CPI forecasts showing the CPI expected to spike about 2 percent over 2021. However, the wide range of forecasts suggests there is a larger than usual degree of uncertainty over the inflation outlook. Capacity pressures are re-emerging, and Covid-19 related supply chain disruptions are also contributing to higher cost pressures.

Finally, there has been a move towards greater nationalistic trade policies world-wide, with some of this sentiment driven by the potential impact of future pandemics and the like encouraging a greater degree of local manufacturing. On the other hand, there is a move to greater protectionism and towards introducing trade barriers into international trading relationships. The potential exists for higher price rises for some products if the traditional safety valve of international competition operates less well than in the past.

Further down the track, the impact of progressively opening the border as vaccinations are rolled out may also affect inflation pressures, depending how open NZ is to immigration and how fast immigration proceeds. Signals suggest the Government may be much more restrictive when it comes to allowing migrants to come to NZ and this could dampen medium term inflationary pressures, particularly housing pressures.

With residential building consents at historical highs, there may hopefully be much more building activity over the next year or so to meet unsatisfied demand. But truly, this is a difficult time to predict future inflationary pressures with any accuracy, as the relatively wide range of forecasts below show.

Forecasts: Percent Change in Inflation (CPI)

	Years Ending		
	Mar 21	Mar 22	Mar 23
Highest	1.5	2.5	2.1
Average	1.5	1.8	1.8
Lowest	1.4	1.4	1.1

Source: ASB, BNZ, Kiwibank and Westpac

1.3 Business activity and confidence – mixed results

Recent surveys of business activity and confidence show significant improvement from the doom and gloom experienced last year. However, while business confidence has improved, it has done so off an extremely low base and therefore the improvement needs to be put in context.

As stated in this report's Executive Summary, the effects of COVID-19 have been extremely uneven across NZ's various sectors.

The impact of the lack of international inbound tourists on tourist-dependent towns such as Queenstown and Rotorua has been massive. While domestic tourists have been out and about, they are no substitute for inbound tourists' deep pockets.

Although many international visitors and students remain in NZ, despite the borders being effectively closed for a year, the absence of the usual seasonal increases in tourism posit-Christmas is now taking a massive toll.

Tourism jobs have taken a pounding over the last year as for all intents and purposes, international tourism has stopped completely.

Likewise, the hospitality sector has been greatly affected with a lack of traditional events adding to the sector's current pessimistic outlook along with changes in alert levels at short notice, all adding to business and household stress. Several hotels have been mothballed, while others are barely getting by with, in many cases, around 50 percent occupancy when pre-Covid, over 90 percent was the norm.

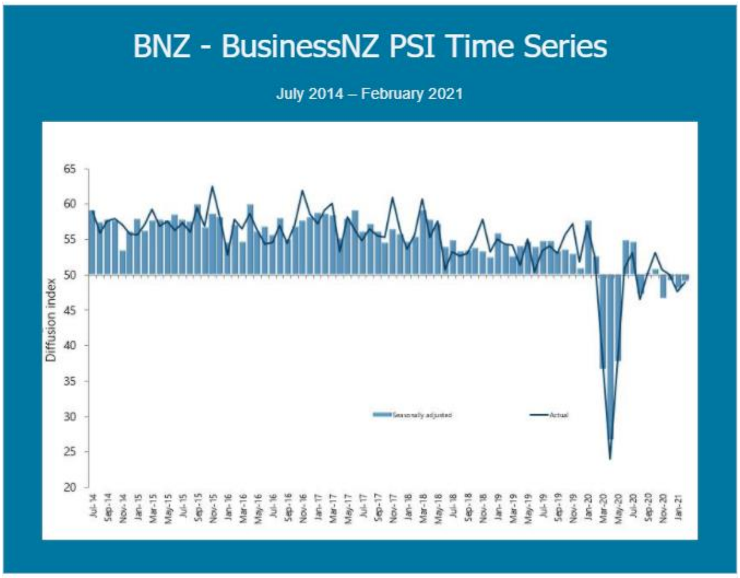
The retail sector is also hurting, and electronic card spending has shown some decline of late. Alert level restrictions on movement and activity have affected spending patterns over February. The time Auckland spent at level 3 while the rest of the country was at level 2, would have been the primary cause of February's reduced spending.

Many retail shops have closed and/or moved increasingly online resulting in increased retail space becoming available, particularly in CBDs. Alongside this, there has been an increase in available office space as companies have restructured and employees have continued to work from home.

Not surprisingly, given all the above factors, the broader services sector is struggling to get back into the black with the BNZ – BusinessNZ Performance of Services Index continuing to remain in negative territory for the fourth consecutive month.

The PSI for February was 49.1 up 1.1 points from January (A PASI reading above 50.0 indicates that the service sector is generally expanding; below 50.0 that it is declining). However, this is still well below the survey's long-term average of 53.8.

While the slight pick-up in activity to levels seen in December was obviously a positive step, the sector remains below the critical 50.0 mark. The last time the sector was in contraction for four consecutive months was during the first half of 2009 – following on from the Global Financial Crisis (GFC).

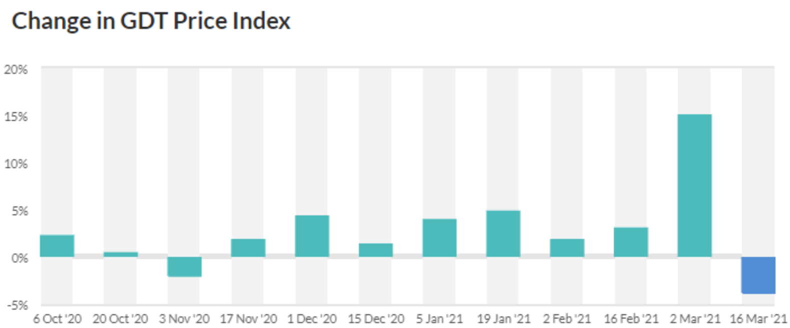


The slower return to business-as-usual post holidays was compounded by two separate lockdown periods in mid and late February, with Auckland hit hardest. This has meant that over February, the key sub-indices of Activity/Sales (50.8) and New Orders/Business (50.3) were both lethargic.

On the other hand, several sectors were doing particularly well, despite the ongoing cloud of Covid-19.

Agricultural sentiment has improved significantly from last year, likely driven by significant rises in commodity prices, with dairy at the front of the pack. Fonterra has again increased its forecast milk payout for the current year, with increased global demand (particularly China, NZ's major trading partner, showing increased demand for product).

The Global Dairy Trade (GDT) has continued to go from strength to strength this year, although the latest result saw a decline of 3.8 percent from the previous auction after eight successive gains, some significant (see below).



Despite improved agricultural sentiment, there is significant concern in the agricultural community and the mineral extraction sector about the potential impact of some aspects of freshwater reform which will adversely affect the ability to use land in an optimal manner. How climate change policy proposals will impact on the agricultural sector in terms of required emission reductions will also be exercising the minds of the sector's leaders.

The construction sector is showing real strength, with a record number of building consents and a particular focus on the Government's massive infrastructure spend down the track. The outlook for construction looks positive both in respect to residential building and the Government's recently announced large infrastructure investments.

Seasonally adjusted new dwelling consents increased by 2.1 percent in the month of January with annual growth up a solid 5.8 percent, to the highest level since 1974.

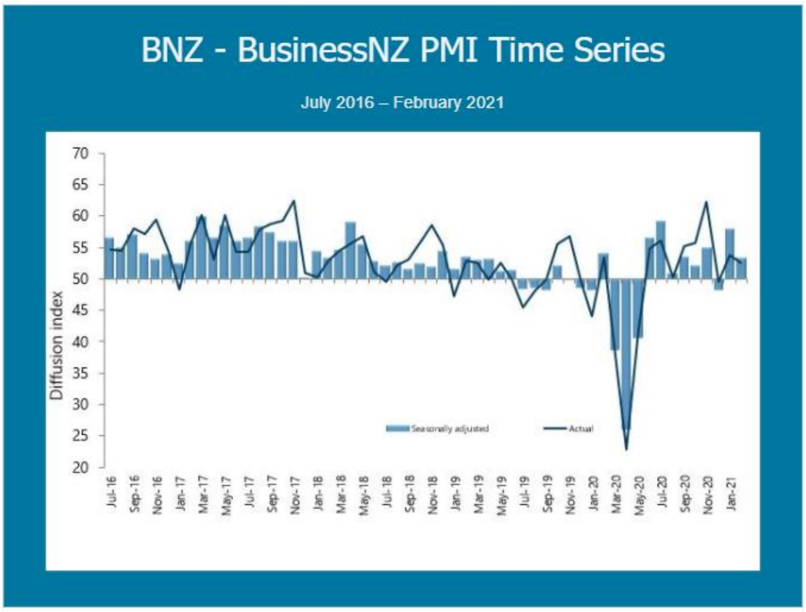
Multi-unit dwelling consents have been the primary driver of increased consents with standalone consents falling slightly. The strong pipeline of consents bodes well for construction activity over the coming year and beyond.

A world of caution though, consents do not necessarily equate to actual building activity.

Numerous blockages prevent building work from coming to fruition and current supply chain issues are greatly affecting the ability to build, as outlined earlier in this report.

Meanwhile, the manufacturing sector seems to be trucking on in a positive manner, although some reduction in the rate of expansion is evident, as shown in the latest BNZ – BusinessNZ Performance of Manufacturing Index (PMI) for February 2021.

The seasonally adjusted PMI for February was 53.4 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). This was down 4.6 points from January but more in line with the long-term average for the PMI (53.0).



The major sub-index values were all down from January. Production (57.3) led the way, followed by New Orders (56.2) but both Employment (49.8) and Deliveries (47.6) remained in contraction, Employment reverting back to levels seen in December 2020.

Despite the PMI remaining in expansion, the proportion of those outlining negative comments stood at 54 percent, compared with 46 percent in January. It remains to be seen what impact the second recent partial lockdown will have on the sector over the next few months.

1.4 Labour market – better than expected but regulatory risks

Perhaps surprisingly, the labour market has performed much better under Covid-19 than the extremely gloomy forecasts outlined a year ago, with unemployment for the forecast period out to March 2023 trending down (see below).

The Government correctly and rapidly tried to ensure employees, during earlier lockdowns, could remain attached to a business operation to the extent possible by providing wage subsidies and other assistance measures to businesses directly, e.g., low interest loans. This has not been without cost. Around $16b has flowed through to keep employees working in the hope of ensuring businesses could get up and running as soon as possible after the various stages of lockdown ended - an appropriate response at the time.

While NZ's current unemployment rate is just under 5 percent according to StatisticsNZ's Household Labour Force Survey (HLFS), this tends to mask the impact Covid-19 has had on specific sectors. And there are still significant concerns about employers' inability to source skilled labour from overseas allowing projects to proceed as well as providing labour to ensure seasonal activities, particularly in the agricultural and horticultural sectors, can be undertaken.

Filled jobs in the December 2020 quarter fell by almost 1 percent or 19,000 jobs, compared with the December 2019 quarter, according to StatisticsNZ.

Several tourist areas of the South Island and Auckland had large falls, although the rest of the North Island fared better.

Filled jobs in the South Island were down 1.7 percent with the largest percentage fall not surprisingly in the Queenstown-Lakes district where filled jobs were down a staggering 9.1 percent.

While such reductions in employment are concerning for specific sectors and regions, it is also important to note that many skills cannot simply be transferred to areas where demand is still strong.

In this respect a greatly reduced ability to source labour from overseas is affecting productivity as there are fewer skilled people in NZ able to do specialist and other necessary tasks. Net migration has effectively reduced to a trickle, limiting the ability of many seasonal operations dependent on foreign-sourced labour to operate as effectively and efficiently as in the past.

It is important for policy makers to understand the contribution migrant employees make to the NZ economy and to individual sectors. These skills cannot, in many if not most, cases, simply be replaced by employing NZ citizens made redundant from their current employment.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Mar 21	Mar 22	Mar 23
Highest	5.1	5.1	4.8
Average	5.1	4.8	4.4
Lowest	5.0	4.6	4.1

Source: ASB, BNZ, Kiwibank and Westpac

Proposed Regulatory Changes

There is a raft of proposed policy changes in the employment relations area, some of which have already taken effect, potentially impacting on the labour costs facing businesses and reducing flexibility, although others, such as the Holidays Act Review, will hopefully clear up the confusion associated with the current legislation.

The proposed regulatory changes are outlined below:

Holidays Act

From around 2014 it became apparent that many employers were not applying the Holidays Act correctly when calculating Holiday Pay. Arrears in many cases totalled tens of millions of dollars. Previous reviews, aimed at clarifying the current Act, pointed to systemic problems that would not be fixed by better explanations. In late 2018, following a joint approach from BusinessNZ and the NZ Council of Trade Unions, the Government commissioned a full review of the Act.

The report of the Holidays Act Task force was released on 23 February 2021, having been accepted by Cabinet in its entirety. A summary of the recommended changes can be found here.

Work will now begin on drafting amendments to the legislation, and this will take some months. Prior to being tabled in Parliament it is expected that an exposure draft of the legislation will be released for consultation. This will provide payroll providers, businesses, and employees with the opportunity to make submissions on the workability of the recommendations. Further submissions will be possible once a Bill has been introduced into Parliament, which may not be until early 2022.

Recently announced amendments to the Holidays Act to increase the minimum sick leave entitlement for 5 to 10 days, and the introduction of a new Matariki public holiday will be passed sooner than the changes recommended in the Taskforce report. The Holidays (Sick Leave) Amendment Bill is currently at the Select Committee stage, while a Bill to enact Matariki is expected later this year.

Fair Pay Agreements

The current government was elected in 2017 with a commitment to introduce Fair Pay Agreements (FPAs), which would be national level industry or occupational instruments negotiated centrally and applied arbitrarily to all workers in in the industry or occupation.

The Fair Pay Agreements Working Group (FPAWG) delivered its report to the Government in December 2018. This was followed in 2019 by a national consultation document that sought views on the Working Group's recommendations. BusinessNZ panned the proposals, pointing out that they effectively recreate the failed national award system that existed in New Zealand between 1894 And 1990.

Social Insurance

Inescapable pressures on the economy, including Covid-19 and climate change, make it clear that significant changes must occur if New Zealand is to sustain itself, let alone grow. This in turn increases the likelihood of large-scale changes in the workforce, including layoffs. To address these changes, the Government is considering introducing a social insurance scheme to augment the current social welfare system. Planning is at the conceptual stage, but any scheme will almost certainly have two main components, an income support mechanism, possibly funded by employee and employer contributions in a manner similar to ACC, and coordinated access to education, vocational training and active labour market policy options designed to "rehabilitate" employees into work comparable in skill and remuneration to their previous employment. While no decisions have yet been taken, it is estimated that a scheme could be implemented as early as 2023.

Pay Equity

The Equal Pay Amendment Act was passed on 6 November 2020. Prior to its passage a range of claims had been made in the state sector which have been dealt with using the set of principles developed in 2016 by the Pay Equity Joint Working Group chaired by Dame Patsy Reddy and now enshrined in the law. Since the Act was passed a further claim has been made for early childhood workers. This is the first real challenge for the Act given the large number of employers working in a sector characterised by a lack of coordination between the various employer groups.

The Government has set up a Data Repository to capture claims' data as claims are settled, providing a research base for future claims. BusinessNZ is a member of the governance group of the Repository, to ensure data relating to private sector claims are managed with appropriate recognition of privacy and commercial confidentiality.

Contractors

Another election commitment made by the Government relates to the provision of better protection for contractors. A wide-ranging discussion paper identifying 11 options (ranging from better enforcement of current law to changing the status of some contractors to employee to bring them under employment law) was released by the Government in 2019. Business NZ provided a comprehensive response.

MBIE officials are still analysing responses to the above discussion document and a decision on the path forward is not expected in 2021. It is noteworthy that recent cases in the USA, UK, Australia and New Zealand have all dealt differently with the status of "platform" workers such as Uber drivers, making government choices in this regard less clear.

Labour Costs – mixed bag

Forecasts below show labour cost increases will likely be subdued over the forecast period.

The game has changed over the last year with significant labour-shedding, particularly in the sectors most adversely affected by border closures, such as tourism and hospitality, and associated industry sectors such as transport. As a result, labour costs are likely to remain flat, with minimal increases expected over the coming year.

On the other hand, the inability to source skilled immigrants from overseas may see some job hopping as businesses compete to obtain required expertise from a diminished pool.

The impact of the impending regulatory cost increases outlined above also needs to be thrown into the mix of factors driving changes in labour costs. While overall, the proposed reforms may result in increased wage rates for some, they will, on the other hand, result in reduced job opportunities for others, if not actual job loss.

Forecasts: Labour cost index percentage change (wages and salaries)

	Years Ending		
	Mar 21	Mar 22	Mar 23
Highest	1.8	2.0	2.4
Average	1.6	1.9	2.1
Lowest	1.5	1.8	1.9

Source: ASB, BNZ, Kiwibank and Westpac